

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF PUBLIC UTILITIES

Petition of Massachusetts Electric Company)
pursuant to Chapter 164, Section 76 and the)
220 CMR 1.00 et seq. for review of its)
electric industry restructuring proposal)

D.P.U. 96-25

Investigation by the Department of Public)
Service upon its own motion commencing)
a Notice of Inquiry/Rulemaking pursuant to)
220 CMR Section 2.00 et seq. establishing)
the procedures to be followed in electric)
industry restructuring by electric companies)
subject to G.L.C. 164)

D.P.U. 96-100

COMMENTS OF
WHEELED ELECTRIC POWER COMPANY
OPPOSING PROPOSED SETTLEMENT

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TABLE OF CONTENTS

OVERVIEW	1
ARGUMENT.....	5
I. STANDARD OFFER.....	5
A. Underpricing Of The Standard Offer.....	5
B. Effects Of Underpricing Standard Offer Service.....	7
C. Essential Changes To The Proposed Standard Offer.....	8
II. UTILITY AFFILIATE PARTICIPATION IN MASS. ELECTRIC’S RETAIL MARKET.....	10
A. Inherent Advantages Of A Utility Affiliate In The Local Retail Electric Market.....	10
B. Failure Of The Settlement To Effectively Address Utility Affiliate Dominance.....	13
C. Remedial Measures.....	14
CONCLUSION.....	17

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COMMENTS OF
WHEELED ELECTRIC POWER COMPANY
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OVERVIEW

Wheeled Electric Power Company (“WEPCO”) is a retail power marketer that is currently participating in retail competition pilot programs in Massachusetts, New Hampshire, New York and Illinois. WEPCO previously participated in the Department of Public Utilities’ Docket No. 96-100, having filed Reply Comments concerning the Department’s Proposed Rules For Electric Industry Restructuring. WEPCO has a very strong interest in the Department’s decision on the Restructuring Settlement Agreement (“Settlement”) proposed by the New England Electric System (“NEES”), Massachusetts Electric Company (Mass. Electric), and the Attorney General. That decision will determine whether the restructuring of NEES and Mass. Electric will in fact lead to effective retail competition and sustainable price reductions, as envisioned in the Department’s Proposed

Rules.

In these Comments, WEPCO urges that the Settlement be rejected because it would preclude the development of effective retail competition and therefore would not produce sustainable price decreases. The failure of competition is inevitable since the Settlement would establish a Standard Offer priced far below the cost of providing retail service, which would create an insurmountable barrier to market entry by alternative suppliers, particularly in the critical early years of retail competition.

As discussed below, the Standard Offer prices would not be sufficient even to recover the cost of wholesale electricity purchases. The disparity between Standard Offer revenues and total costs would be even greater since expenses incurred in administering the program--e.g., customer service, invoicing, data processing and legal expenses--must also be factored in.

Alternative suppliers who would have to incur similar wholesale purchasing costs and administrative costs could not compete against the Standard Offer. They would have to absorb enormous losses just to match the Standard Offer price, and would have to incur even greater losses to attract customers away from Standard Offer service. Clearly, effective retail competition is impossible under these circumstances.

The underpricing of Standard Offer service is exacerbated by the fact that those prices are largely insulated from underrecoveries of revenues relative to the cost of providing the service. In contrast, alternative suppliers must reflect the risk of underrecovering their costs in the prices they charge consumers.

In addition to the drastic underpricing of Standard Offer service, the Settlement would further undermine efforts to develop robust retail competition by allowing an affiliate of NEES and Mass. Electric--ALLEnergy--to sell retail electric service in Mass. Electric's territory. Although the Settlement would establish rules prohibiting certain actions by Mass. Electric favoring ALLEnergy (Settlement, Attachment 14), it would not bar ALLEnergy from exploiting the inherent benefits of its affiliation with Mass. Electric and NEES. ALLEnergy would have the advantage of being associated with the local utility which has been providing electricity service for decades, as well as the expertise, experience and customer contacts of Mass. Electric employees who will be transferred to ALLEnergy. Moreover, the very sizable war chest accumulated by NEES from the sale of its generation assets and recovery of potential stranded costs could be used to subsidize ALLEnergy's retail marketing efforts in the Mass. Electric service area.

In view of these considerations, the Settlement is inimical to the public interest and should be rejected. The Settlement would not meet the Department's goal of ensuring effective retail competition. Instead, the traditional monopoly service provided by Mass. Electric would be replaced by Standard Offer service, with no realistic opportunity for robust retail competition to develop at least for several years. Consequently, the competitive forces needed to sustain rate decreases in the long run would not be achieved.

Given the momentous changes proposed in the Settlement, their impact on Massachusetts consumers and the State's economy, and their potentially devastating effect on the development of competition, the Settlement should be evaluated in hearings where parties would be able to present knowledgeable witnesses and question the Settlement's proponents in detail. This is necessary to ensure that the Department's decision will be based

on a comprehensive record. Such a procedure could be accomplished without delaying the start of retail competition, which is targeted for January 1998.

Fundamental changes in the proposed restructuring of NEES and Mass. Electric must be adopted to ensure that effective competition is established and that substantial, sustainable rate reductions are achieved. Those changes include:

1. Standard Offer

a. The retail Standard Offer price should be market-based and determined strictly through competitive bidding, and should reflect both wholesale purchasing and administrative costs.

b. To the extent that the prices for Standard Offer service established through competitive bidding are above the levels specified in the Settlement, those differentials should be offset by reductions in the access charge to ensure that the targeted minimum overall rate decreases are realized.

2. Utility Affiliate Participation In Mass. Electric Retail Market

a. Given the enormous inherent advantage of its affiliation with Mass. Electric, ALLEnergy should be barred from selling at retail in the Mass. Electric service area for the first two years after retail competition is initiated, or at an earlier date if it can be demonstrated to the Department that the affiliate lacks market power.

b. If, contrary to our recommendation, ALLEnergy were allowed to sell at retail in the Mass. Electric service area, a number of measures should be adopted so that the advantages of utility affiliation are offset to some degree. Those measures should include but not be limited to prohibiting ALLEnergy from representing to consumers that it is more reliable than other qualified vendors; barring ALLEnergy from using the utility's name and logo in its marketing; requiring the imputation of reasonable royalty payments from ALLEnergy to the utility; and establishing an expedited procedure for the Department to review complaint regarding anti-competitive practices.

ARGUMENT

I. STANDARD OFFER

In its May 1, 1996 Restructuring Order, the Department recognized that a truly competitive retail market must have “(1) many buyers and sellers with effective access to each other, (2) arms-length transactions between buyers and sellers, (3) broad and equal access to timely market information, and (4) low thresholds for entry.” (Order at 12) The proposed Settlement fails to meet those tests, particularly because the Standard Offer price would be substantially below the wholesale price of electricity and thereby preclude effective competition.

A. Underpricing Of The Standard Offer

The Settlement would provide a Standard Offer option from 1998 to 2004 for those customers who do not choose to take service from an alternate supplier. The charge for Standard Offer service would be set initially at 2.8 cents per kwh in 1998 and would increase by approximately 10% a year to 5.1 cents per kwh in 2004. After 2004, Standard Offer service would not be available.

These Standard Offer prices are stipulated amounts. They are not market-based. In fact, the Standard Offer prices are substantially below the projected wholesale prices for New England in 1998 through 2001 as shown in Table 1 on page 6. The projected wholesale prices in Table 1 are discussed in Appendix A, the October 1996 prefiled testimony of Frank

P. Sabatino, Vice President of Wholesale Marketing for Northeast Utilities Service Company and Chairman of the Executive Committee of the New England Power Pool, in New Hampshire Public Utilities Commission Docket No. DR 96-150.

TABLE 1

<u>Year</u>	<u>Standard Offer Price (Cents per kwh)</u>	<u>Projected Wholesale Price (Cents per kwh)</u>
1998	2.8	3.07
1999	3.1	3.26
2000	3.4	3.59
2001	3.8	3.93

The disparity between Standard Offer revenues and total costs would be even greater since expenses incurred in administering the program must be factored in. Mass. Electric would require substantial expenditures on customer service, invoicing, data processing, collections, advertising, legal services and overall management in providing Standard Offer Service.

Alternative suppliers who would have to incur similar wholesale purchasing costs and administrative costs could not compete against the underpriced Standard Offer. They would have to absorb enormous losses just to match the Standard Offer price. Moreover, to induce customers to sign up, they would have to charge lower rates than for Standard Offer service. Thus, alternative suppliers would lose substantial amounts on each kwh they sold.

The disadvantage faced by alternative suppliers is worsened by mechanisms which insulate the Standard Offer from underrecoveries of revenues relative to costs. Although Standard Offer prices are projected to be substantially below the cost of providing that service in the early years of the Settlement, those prices may not be adjusted to reflect such shortfalls. A surcharge could be added on to the Standard Offer price to recoup the shortfalls. However, the surcharge could be applied (1) only to the extent that it did not cause the total price of retail delivery service plus the Standard Offer to exceed the inflation cap (Settlement, Book 1, page 36) and (2) only to the extent that access charges are below the unadjusted contract termination charges. (*Id.*, pages 34-35) Moreover, the Standard Offer underrecoveries that are not recouped before the Standard Offer ends in December 2004 could first be recovered starting in 2010, subject to a cap of 0.4 cents per kwh. These mechanisms further prejudice alternative suppliers who must reflect the risks of underrecoveries in their prices.

B. Effects Of Underpricing Standard Offer Service

It is unlikely that alternative suppliers would enter the market under the conditions prescribed in the Settlement. Although many suppliers participating in the New Hampshire pilot program offered retail rates below wholesale power prices, they did so to gain experience on a small scale in marketing and providing service. The program was limited to 17,000 customers with a total demand of 50 megawatts (Mw) and the potential losses for suppliers were therefore relatively limited. For example, even for a very aggressive supplier which expected to achieve a 25% market share, each mil of discount resulted in a total cost of \$65,000 a year for all of the suppliers' customers in the state.

The Mass. Electric situation is vastly different. It would involve a full scale retail system. All one million customers in the utilities' service area, with a total demand of approximately 3,000 Mw, would have to take service either from retail marketers or under the Standard Offer. Given the substantial losses that would have to be incurred in providing service, few, if any, consumers in the Mass. Electric service area would have access to retail marketers for several years--at least apparently through 2001 based on the projections in Table 1. Alternative supply options probably would not become available until later when the Standard Offer price increases to levels above wholesale electricity prices.

Thus, the end result for almost all customers in the first few years of restructuring would be the substitution of Standard Offer service for Mass. Electric monopoly service. That is clearly not the retail choice environment envisioned by the Department in its Proposed Rules For Electric Industry Restructuring.

The only retail activity that might occur in these circumstances is entry by very large entities which could afford to absorb considerable losses in selling below wholesale prices to capture market share. But that would be predatory pricing--not competition. Other retailers would not be able to match such prices and would lose market share opportunities at the outset. Those other retailers would then be at a distinct disadvantage later on when the Standard Offer was priced reasonably and realistic competition was possible.

The early years of retail competition will be critical. If restructuring is not designed properly, the development of a robust competitive market will be thwarted. The Department's goals of low thresholds for entry and a market with many buyers and sellers having effective access to each other will not be realized. It is essential that all potential

entrants be given the opportunity to compete fairly on a level playing field in the new electricity retail market. The proposed Settlement, however, would preclude this from happening.

C. Essential Changes To The Proposed Standard Offer

By stipulating Standard Offer prices rather than relying on market-based determinations, the Settlement introduces the potential for economic distortion. In fact, as noted in Points I-A and I-B above, the distortions would be very pronounced and would undermine the Department's goal of achieving robust retail competition. Alternative suppliers are likely to be kept out of the market because the Standard Offer is so sharply underpriced.

There is no justification for such distortions. They can be readily avoided by setting the Standard Offer price on the basis of competitive bidding.¹ By doing so, the Standard Offer will reflect market conditions--the same market conditions faced by alternative suppliers who must compete with Standard Offer service.

The market-determined price for the Standard Offer must include the full cost of administering the program.² To do otherwise would place suppliers offering alternatives to

¹ Ironically, the Settlement specifies a bidding procedure for supplying Standard Offer service to Mass. Electric (Settlement, Book 2, pages 95-101), but not to retail customers. It would establish a schedule of prices that Mass. Electric would pay to New England Power in the event there were insufficient bids to supply Standard Offer service at discounts from that schedule. That bidding process, however, would not produce market-based rates at the retail level since the Standard Offer price for Mass. Electric retail customers is set on the basis of a stipulated schedule, as discussed above.

² As a general matter, the commercial activity of a utility should never be subsidized by wires charges paid by all customers. This principle should be applied other utility activities in addition to Standard Offer service. Thus, contrary to the Settlement (Book 1, pages 35-36), Mass. Electric should not be allowed to recover the cost of providing basic service to a customer during a hiatus between suppliers from other customers through a wires charge.

Standard Offer service at an unreasonable disadvantage. They would have to recover the same types of administrative costs in the prices they charged their customers, whereas the Standard Offer administrative costs would be free of such charges.

Since the market-determined price for the Standard Offer will be substantially greater than the Settlement's stipulated rates for that service, the total charges paid by Standard Offer customers will increase above the levels specified in the Settlement. This would frustrate the goal of 10% minimum overall decreases. Accordingly, to the extent that the prices for Standard Offer service established through competitive bidding exceed the levels specified in the Settlement, those differentials should be offset by reductions in the access charges to the extent necessary for ensuring that the targeted overall rate decreases are achieved.

Reductions in the access charge could be accomplished without significantly affecting the basic premises of the Settlement. The access charge schedules presented in the Settlement are "placeholder" numbers. (Settlement, Book 3, page 63) They will be reduced significantly in light of the residual value credit, which will reflect Mass. Electric's share of the net proceeds received by New England Power from the sale of its generation assets. (Settlement, Book 2, pages 52-53, 63) With those reductions, the total rates for customers who take Standard Offer service based on market-determined prices may very well be below the targets specified in the Settlement. Nevertheless, if that is not the case, the schedule for access charge recovery could readily be adjusted to keep total rates within the targeted range.

In this way, the goal of ensuring effective competition through market-determined Standard Offer prices can be reconciled with the goal of achieving the targeted rate

reductions. Moreover, by helping facilitate the development of effective competition, this will create an environment in which the rate reductions can be sustained and extended. Conversely, failure to couple price reductions with a robust retail competitive market will cause the Settlement's assumed rate reductions to be transitory and illusory.

II. UTILITY AFFILIATE PARTICIPATION IN MASS. ELECTRIC'S RETAIL MARKET

A. Inherent Advantages Of A Utility Affiliate In The Local Retail Electric Market

The Settlement's purported objective of creating efficient retail electric supply competition is undermined by provisions which would allow an affiliate of Mass. Electric--ALLEnergy-- to participate in that market. (Settlement , Book 3, page 53)³ As an affiliate of Mass. Electric, ALLEnergy would have an enormous inherent advantage over other retail suppliers.

First, ALLEnergy would benefit greatly from being connected with the utility which has been providing electricity service in the local area for decades. The mere fact of that identity would produce immediate recognition and credibility for ALLEnergy. Consumers would naturally associate the affiliate with Mass. Electric's vast experience in the region. ALLEnergy would seek to reinforce that association by promoting itself as Mass. Electric's sister company and using the same logo as the utility. In contrast, other retail marketers will have to invest substantial money and effort to develop recognition and credibility with Mass. Electric area consumers. They would be starting from scratch, with no track record.

³The Settlement would also allow Mass. Electric affiliates to re-enter the generation business following the completion of divestiture, and to market electricity and other energy sources anywhere. (Id.)

Second, ALLEnergy would also benefit greatly from the expertise, experience and customer contacts of employees who are transferred from Mass. Electric. Such individuals would have unique knowledge of electricity operations and markets in the Mass. Electric area, which they would bring to ALLEnergy. In contrast, other entities seeking to compete in that area would have to incur considerable expense to acquire or develop such knowledge. Moreover, they probably would have to offer substantial premiums to hire away Mass. Electric employees compared to what ALLEnergy would pay.

For example, the NEES/Mass. Electric corporate group could readily identify the individuals with the expertise and record of reliable work who are needed to staff ALLEnergy. Other retail marketers, however, would have to spend time and money identifying , recruiting and interviewing such individuals. Further, individuals transferring from Mass. Electric to ALLEnergy would remain within the same corporate group and presumably would continue in their pension plans and retain their seniority rights. Other companies seeking to hire such individuals would have to pay a considerable premium to compensate for the loss of those benefits.

Third, ALLEnergy would utilize NEES's considerable financial resources. With the contemplated sale of NEES's generation assets and the Settlement's provisions regarding the recovery of potential assets, NEES will accumulate an immense war chest. Those funds would not be committed to or encumbered by any endeavor. Under the Settlement, they could be invested anywhere. Nothing in the Settlement prohibits NEES affiliates from marketing electricity or other energy sources or services in the Mass. Electric service area or anywhere else. (Settlement, Book 1, page 53) (Nor does the Settlement bar NEES

affiliates from re-entering the generation business following the divestiture of generation assets.)

With the backing of NEES's war chest and balance sheet, ALLEnergy could readily afford to absorb substantial near term losses to gain market share in Mass. Electric's service and fend off potential competitors. That financial strength coupled with the inherent advantages of affiliation with the local utility would pose a very serious threat to the development of effective competition.

Experience in electric retail pilot programs in Massachusetts, New Hampshire and Illinois demonstrates that this cannot be dismissed as an idle concern. In the Mass. Electric pilot program, in which retail service will start on January 1, 1997, a Northeast Utilities affiliate is marketing on the basis of a 2.2 cents per kwh bid. That bid is far below the projected 1997 wholesale price of 2.94 cents per kwh. (Appendix A, page 7) (Ironically, at the same that one Northeast Utilities affiliate is selling power at a loss in a retail competition program, a Northeast Utilities operating company--Connecticut Power and Light--is claiming financial distress because of losses in its utility business.)

In New Hampshire, the entrenched utilities made every effort to maintain their dominance. They used high levels of stranded cost recovery in their current rates to cut retail prices in the pilot program and engaged in sharp discounting to prevent new entrants from gaining access to the market. Indeed, the utilities have reduced retail prices below wholesale prices.

In the Central Illinois Light Company (CILCO) pilot, the utility's affiliate, QST,

promoting itself as CILCO's "sister company," and claimed that it therefore was the only retail marketer that could provide the same reliable service consumers had experienced with the utility.⁴ The affiliate's efforts to closely identify itself with the utility was reinforced by its use of the utility's logo. It has been reported that the utility affiliate, QST, has realized a 96% market share among customers opting for alternative suppliers.⁵

B. Failure Of The Settlement To Effectively Address Utility Affiliate Dominance

The Settlement does not effectively address the problem of potential utility affiliate dominance in the local retail market. As noted above, the Settlement would allow ALLEnergy to sell electricity in Mass. Electric's service territory and would place no restrictions on the use of NEES's financial resources to support such activity. While Standards of Conduct concerning Mass. Electric's action vis-à-vis ALLEnergy are included in the Settlement (Book 3, pages 238-243), approval of the Standards is not a condition of the Settlement.

Moreover, although the Standards include prohibitions against certain actions by Mass. Electric employees that would favor ALLEnergy, they do not negate the inherent advantages that ALLEnergy would enjoy as a utility affiliate nor do they bar ALLEnergy from conduct that would exploit those advantages. For example, the Standards provide that Mass. Electric employees cannot state or imply that customers choosing service from ALLEnergy will receive preferential treatment from Mass. Electric. However, nothing in the

⁴ WEPCO filed a complaint with the Illinois Commerce Commission (ICC) regarding anti-competitive actions by CILCO and QST in the CILCO pilot. (ICC Docket No. 96-0405) The complaint was withdrawn by letter dated October 28, 1996, in light of a settlement with CILCO under which the utility agreed to open new pilot areas.

⁵ Power Markets Week, August 5, 1996, page 6.

Standards precludes ALLEnergy from promoting itself as a “sister company” of Mass. Electric or claiming that it is the only retailer that can provide the same reliable service customers previously received from Mass. Electric. Nor does the Settlement contain provisions regarding the use of Mass. Electric’s logo and other trademarks by ALLEnergy.

Similarly, the Standards of Conduct prohibit Mass. Electric employees transferring to ALLEnergy from taking files or copies of files with them. (Settlement, Book 3, page 241) However, such employees would obviously take the expertise experience and customer contacts that they developed at Mass. Electric to ALLEnergy.

Further, although there is a provision that allegations concerning violations of the Standards of Conduct would be investigated by Mass. Electric, there is no mechanism for bringing complaints regarding anti-competitive practices before the Department--much less an expedited procedure for dealing with such complaints.

C. Remedial Measures

The advantages of a utility affiliate in the local retail electric market are so powerful that they threaten to preclude the development of effective competition. This problem should be addressed by barring ALLEnergy and other NEES affiliates from selling at retail in the Mass. Electric service area for the first two years after retail competition is initiated, or at an earlier date if it can be demonstrated to the Department that the affiliate lacks market power. Such a determination is clearly within the domain of the Department which has been and will continue to be required to evaluate market power issues as competition accelerates in traditional utility sectors. The procedure recommended here will help ensure a truly level playing field, with no one retailer in a position at the start to dominate the market by virtue

of its unique association with the historic monopoly service provider.

The affiliate of the local utility would not be unduly prejudiced by this measure. There are 137 utility service areas in the United States. Thus, the affiliate could choose from 136 other service areas where it would be able to compete. NEES and Mass. Electric might claim that it would be unfair to bar their affiliate from the Mass. Electric service area while allowing other companies to compete without knowing whether ALLEnergy will be able to compete elsewhere. That notion has no validity, at least with respect to service areas elsewhere in Massachusetts and in neighboring states. Massachusetts is clearly committed to open access, as are New Hampshire, Rhode Island and New York.

If, contrary to our recommendations, ALLEnergy were permitted to sell at retail in Mass. Electric's service area, a number of measures should be adopted so that the advantages of utility affiliation are offset to some degree. Those measures should include, but not be limited to the following items.

First, ALLEnergy should be prohibited from representing to consumers that it is a "sister company" of Mass. Electric or that it would provide better quality service than other retailers because of its utility affiliation. Absent those prohibitions, ALLEnergy would gain an unfair advantage over other competitors. WEPCO's experience in the CILCO pilot program in Illinois indicated that this type of marketing was a major factor in the utility affiliate gaining a 96% market share.

Second, ALLEnergy should be barred from using Mass. Electric's logo and other trademarks. The use of such symbols would prompt consumers to think of ALLEnergy as

part of Mass. Electric, having a special status distinct from other retailers.

Third, royalty payments from ALLEnergy for the inherent benefits of its affiliation with Mass. Electric should be imputed to the reduce the utility's revenue requirement for the wires charge. Many of the inherent benefits of utility affiliation would remain despite efforts to mitigate them. For example, a utility affiliate would always be able to rely on the financial strength of the utility, which will continue to have a monopoly in the provision of transmission and distribution service. Further, as noted above, while employees transferring from the utility could be prevented from taking files with them, nothing could stop them from bringing their general knowledge to the affiliate. Since utility customers paid for developing the reputation, financial strength and employee knowledge base that is so critical to utility affiliates, customers are entitled to be compensated through lower rates reflecting royalty imputations when such attributes are bestowed upon affiliates. (Rochester Telephone Corporation v. Public Service Commission, 87 N.Y.2d 17 (1995)) Further, to the extent that a royalty required a utility affiliate to pay for assets it otherwise would receive without any compensation, it would levelize the playing field vis-à-vis competitors who have to pay for such assets in the open market.

Fourth, an expedited procedure is needed to handle complaints to the Department regarding possible anti-competitive practices in a retail competition environment.⁶ Prompt action on such matters will be essential since entrants could irrevocably lose substantial market share, especially in the early stages of competition, if improper conduct goes

⁶ In Illinois, WEPCO's complaint regarding anti-competitive practices in the CILCO pilot program was set down for a traditional formal hearing process in which a schedule of at least eight months was contemplated. As noted above, the complaint was withdrawn pursuant to a settlement.

unchecked.

CONCLUSION

For the reasons stated above, WEPCO urges the Department to reject the proposed Settlement and to adopt the recommendations presented here in formulating a plan for restructuring the operations of NEES and Mass. Electric, and implementing retail competition.

Respectfully submitted,

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